

# ANALYSIS OF ORIGINAL BILL

## Franchise Tax Board

Author: Hollingsworth Analyst: Nicole Kwon Bill Number: SB 26  
Related Bills: See Legislative History Telephone: 845-6458 Introduced Date: 12-08-2004  
Attorney: Patrick Kusiak Sponsor: \_\_\_\_\_

**SUBJECT:** PIT Rates/Reduce All Marginal Tax Rates Beginning On or After January 1, 2005 & Eliminate Alternative Minimum Tax Beginning On or After January 1, 2009/Repeal 1% Additional Tax On Income Over \$1 Million For Mental Health Services (Prop 63)

### SUMMARY

This bill would:

- reduce all personal income tax (PIT) rates over a five-year period to zero,
- eliminate the alternative minimum tax (AMT) by January 1, 2009,
- modify how nonresidents and part-year residents are taxed, and
- repeal Proposition 63 that imposes an additional 1% tax on the portion of a taxpayer's taxable income (TI) that exceeds \$1,000,000.

### PURPOSE OF THE BILL

According to the author's office, the purpose of the bill is to alleviate the tax burden for all taxpayers.

### EFFECTIVE/OPERATIVE DATE

As a tax levy, this bill would be effective immediately and apply to taxable years beginning on or after January 1, 2005.

The repeal of the Proposition 63 provisions would be operative if presented to and approved by California voters.

### POSITION

Pending.

### ANALYSIS

#### FEDERAL/STATE LAW

Federal law imposes five different income tax rates on individuals ranging from 10% to 39.6%. Existing state law imposes six different PIT tax rates ranging from 1% to 9.3%. Each tax rate applies to a different level of income and is also known as a "tax bracket."

Board Position:

_____ S	_____ NA	_____ NP
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_____ N	_____ OUA	<u>  X  </u> PENDING

Department Director

Date

Gerald H. Goldberg

2/7/05

Existing federal and state laws provide for an AMT liability, which ensures that taxpayers with substantial economic income and credits, deductions, and other preference items do not completely escape taxation. Taxpayers that benefit from these special treatment deductions and credits must pay at least a minimum amount of tax. Federal law provides a personal income AMT rate of 26%, and the state provides a personal income AMT rate of 7%. The state AMT is a tax equal to the excess, if any, of the tentative minimum tax over the regular tax. The tentative minimum tax is computed in accordance with Internal Revenue Code (IRC) section 55 through section 59.

Current state law requires the Franchise Tax Board (FTB) to index the tax brackets and the AMT exemption amounts each year to account for inflation.

Residents of California are taxed on their entire TI regardless of source while nonresidents are taxed only on TI from California sources. A part-year California resident's TI for the year they change residency is the sum of the entire TI during the portion of the year they were a resident and the TI from California sources during the portion of the year the taxpayer was a nonresident.

The current law for net operating loss (NOL) deduction allowed in computing the TI of a nonresident or part-year resident no longer limits the amount of NOL allowed in computing the "amount of total TI" but is a separate computation.

Proposition 63 approved by voters in the November 2004 General Election provides a dedicated funding source for the expansion of mental health treatment options for children, adults, and seniors as follows:

- Starting with the 2005 tax return, it imposes an additional 1% tax, not subject to reduction by credits, on the portion of a taxpayer's TI that exceeds \$1,000,000.
- The estimated revenue from that additional 1% tax is deposited in the Mental Health Services (MHS) Fund on a monthly basis, subject to an annual adjustment.

### THIS BILL

Beginning with the 2005 taxable year, this bill would incrementally reduce all PIT rates to zero by January 1, 2009. This bill would effectively eliminate PIT.

The PIT tax rates proposed by this bill are in the following table:

<u>PIT Tax Rates</u>					
<i>Current (2004)</i>	<i>2005</i>	<i>2006</i>	<i>2007</i>	<i>2008</i>	<i>2009</i>
1%	0.80%	0.60%	0.40%	0.20%	0%
2%	1.6%	1.2%	0.80%	0.40%	0%
4%	3.2%	2.4%	1.6%	0.80%	0%
6%	4.8%	3.6%	2.4%	1.2%	0%
8%	6.4%	4.8%	3.2%	1.6%	0%
9.3%	7.54%	5.58%	3.72%	1.86%	0%

This bill would apply to individuals, both residents and nonresidents, sole proprietorships, estates, and trusts.

This bill would repeal the AMT chapter of the Revenue and Taxation Code (R&TC) as of January 1, 2009.

This bill would delete the current rules used by nonresidents and part-year residents for calculating the rate of tax based on income sources. The current mathematical formula is:

$$\frac{\text{Tax on Total TI}}{\text{Total TI}} \times \text{California Source TI} = \text{Pro-rated Tax}$$

This bill would provide that the amount of tax imposed on a nonresident or part-year resident of California would be computed upon the total income of the individual, as if that individual were a resident of California for the entire year. The resulting amount of tax would be prorated based upon the ratio of adjusted gross income (AGI) with a source in California over AGI from all sources. The mathematical formula under this bill would be:

$$\text{Tax on Total TI} \times \frac{\text{California Source AGI}}{\text{Total AGI From All Sources}} = \text{Pro-rated Tax}$$

Also, this bill would eliminate the current method of determining carryover items, deferred deductions, deferred income, and itemized deductions for nonresidents and part-year residents.

This bill would repeal Proposition 63 and the revenue allocations that are to be transferred to the MHS Fund. These provisions would only be repealed when submitted to and approved by the voters of California.

### IMPLEMENTATION CONSIDERATIONS

Reducing the PIT rate would require some changes to existing tax forms and instructions and information systems and could be accomplished during the normal annual update. However, the rate reduction would result in the elimination of many of the PIT programs within FTB by 2009. This would reduce a large amount of FTB's workload and the revenue generated for the General Fund.

The author's staff has indicated the changes made by this bill regarding the calculation of tax and other items for nonresidents and part-year residents were not intended. However, until the bill is amended the following implementation concern applies:

- ❖ Current law provides a specific method to determine carryover amounts, deductions, and deferrals of income for nonresidents and part-year residents. This bill would eliminate that method and does not specify how the computation for these complex computations would be made.

## TECHNICAL CONSIDERATIONS

On page 10, line 19, Section 6 refers to Sections 2 to 5, inclusive. Section 3 would repeal AMT beginning in 2009. AMT would not need to be submitted to and approved by the voters. For clarity, the author may wish to revise the language within Section 6 to exclude Section 3 or renumber each of the sections.

The majority of the Personal Income Tax Laws (PITL), certain articles pertaining to personal income tax in the Administration of the Franchise and Income Tax Laws, Homeowner's and Renter's Assistance Law, and the Taxpayer Bill of Rights would need to be repealed or amended to reflect the elimination of the PIT tax rates by the year 2009.

The corresponding sections relating to the calculation of tax within the R&TC for nonresidents and part-year residents would need to be amended to maintain consistency.

Department staff is available to assist with these amendments.

## **LEGISLATIVE HISTORY**

SB 4 (Hollingsworth, 2003/2004) and AB 17 (Hollingsworth, 2001/2002) were identical to this bill, but did not contain the Proposition 63 provisions. SB 4 would have also eliminated AMT. SB 4 was amended on May 1, 2004, to exclude from gross income interest payments on government insurance proceeds received by a widow or child from an individual who died in combat while on active duty. SB 4 and AB 17 failed to pass out of the house of origin.

AB 1224 (Rod Pacheco, 2001/2002) would have eliminated the lowest PIT rate bracket of 1% for all PIT taxpayers. It also would decrease all remaining PIT tax rate brackets by the year 2003. This bill failed to pass out of the first house by January 31 of the second year of the session.

## **OTHER STATES' INFORMATION**

*Florida* does not have a personal income tax. *Illinois* has a flat tax rate of 3%. *Massachusetts* has a split rate, a flat tax rate of 5.3% for most income, and 12% for certain capital gains, dividends, and interest. *Michigan* has a flat tax rate of 4%. *Minnesota* has a progressive rate with a maximum rate of 7.85%. *New York* has a progressive rate with a maximum rate of 6.85%. All these rates are for the 2004 tax year. The laws of these states were reviewed because their tax laws are similar to California's income tax laws.

## **FISCAL IMPACT**

Initially, this bill would not significantly impact the department's costs, as the same number of taxpayers would still be filing returns. Eventual elimination of the PIT programs would result in substantial cost savings for the department's budget. However, the department would still administer the AMT until 2009, the refundable Child and Dependent Care Credit under the PITL, the Homeowner's and Renter's Assistance Program, the corporate tax, and the various non-tax debt collection programs that includes child support until it is transferred to the Department of Child Support Services.

Under Proposition 63, FTB has estimated a startup cost of \$1,170,000 and ongoing costs of \$742,000. If it is repealed by the voters, FTB costs (other than start-up costs) to administer and maintain this program would be eliminated.

## ECONOMIC IMPACT

### Revenue Estimate

Based on the data and assumptions below, revenue effects are as follows:

Estimated Revenue Loss of SB 26 Beginning On Or After January 1, 2005, Ending December 31, 2010 Assume Enactment After June 30, 2005 (\$ Billions)					
Fiscal Year	2005-06	2006-07	2007-08	2008-09	2009-10
Personal Income Tax Rate Reductions	-\$13.3	-\$16.5	-\$21.1	-\$33.3	-\$48.8
Elim. 1% Add'l Tax	-\$0.94	-\$0.69	-\$0.73	-\$0.78	-\$0.84
TOTAL	-\$14.2	-\$17.2	-\$21.8	-\$34.1	-\$49.6

This analysis does not consider the possible changes in employment, personal income, or gross state product that could result from this measure.

### Revenue Discussion

The above estimates are based on the department's current personal income tax model. These estimates incorporate the elimination of the AMT rate in 2009, resulting in a sharp loss in the 2008-09 fiscal year.

The revenue impact for repealing the additional 1% tax on the portion of a taxpayer's taxable income that exceeds \$1 million was based on the revenue contained in Proposition 63 as shown below:

<u>Applicable Fiscal Year</u>	<u>Estimated Revenue From Additional Tax</u>
2004-05	\$ 254 million
2005-06	\$ 683 million
2006-07	\$ 690 million
2007-08	\$ 733 million
2008-09 and later	annual growth of 7% of preceding fiscal year

## **ARGUMENTS/POLICY CONCERNS**

This bill would reduce the regular tax rates incrementally over four years. However, current law requires a taxpayer to pay either the regular tax or the tentative minimum tax, whichever is higher. Since this bill does not make a corresponding reduction in tentative minimum tax until the AMT is eliminate in 2009, all taxpayers would be required to pay the higher tentative minimum tax at some point between 2005 and 2009.

Income taxes for sole proprietorships would be reduced and eventually eliminated by this bill. However, C and S corporations, partnerships, and limited liability companies would continue to pay taxes and fees under existing law, thus creating different treatment for businesses based on their entity type.

## **LEGISLATIVE STAFF CONTACT**

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